BEFORE THE

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TRANSPORTATION

AND

INFRASTRUCTURE

U.S. House of Representatives

HEARING ON RAIL COMPETITION AND SERVICE

STATEMENT

OF

WILLIAM J. RENNICKE

DIRECTOR

OLIVER WYMAN, INC.

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I. Statement of William J. Rennicke, Director, Oliver Wyman, Inc.

Good morning. I am William J. Rennicke, a Director at Oliver Wyman. Since I started my transportation carrier over 40 years ago as a brakeman on the bankrupt New Haven Railroad, I have been an active participant both in carrier operations and management and as an advisor to the transportation industry, governments, and to users of transportation worldwide.

In the late 1970's, I was fortunate to be an active participant in the public and legislative process that led to the Staggers Act. At the time, I was the Vice President and Assistant to the President of the bankrupt Boston & Maine Railroad, which as you may recall was the only one of the "Eastern Bankrupts" that was not consolidated into Conrail. I believe that at the time the Boston & Maine's input was frequently considered, since we were the only bankrupt railroad that was able to reorganize totally within the private sector and, with the exception of one infrastructure loan, essentially without the use of any public funds.

I believe that Congress, shippers, the carriers, labor, and all other industry participants should be quite proud of the results of the Staggers Act and the subsequent restructuring of the U.S. rail industry. From the late 1960's through the mid-1970's, over half of the U.S. rail system was in bankruptcy and financial distress. The Staggers Act turned the rail industry into a self-sustaining freight network, and the U.S. regulatory and carrier model is now seen as a standard and benchmark for freight rail systems worldwide. The Staggers Act also played an important role in eliminating or mitigating the substantial risk and uncertainty penalties that the financial community placed on rail investments, saving both carriers and shippers hundreds of millions of dollars over the past 27 years.

Because of our private sector experience in the restructuring of the U.S. rail industry, both I and Oliver Wyman have been asked by governments, shippers, and carriers on six continents to take the lessons learned in the United States and apply them to improving local rail systems. Starting in the late 1980's, I participated in the privatization of the Argentine railroads – the first railway privatization since World War II. Due to our success there and elsewhere, Oliver Wyman has subsequently participated in major rail privatizations and restructurings worldwide. For example, we were asked to manage the initial restructuring process for state-owned railroads in Poland, Hungary, and the Czech Republic, only months after each saw a change in political control. I also managed the concessioning of the Mexican railway – turning it from a money-losing government enterprise into several successful private carriers – and in Canada we participated in the privatization of the Canadian National Railway.

In every country where we have worked, the objectives of restructuring have been to create a self-sustaining railway network that supports the domestic economy, facilitates international trade, is funded as much as possible by the private sector, and that improves the rail sector's risk profile and attractiveness to the capital markets. However, despite decades of effort in other parts of the world, with the exception of the United States, Canada, and to some extent Mexico (together with several private iron ore, coal, and mineral railroads), no rail system anywhere in the world survives without direct or indirect support from the government and taxpayers. The billions spent by the U.S. government to correct the Conrail situation was the last significant payment of federal funds in the United States for a freight railroad. I believe proposed provisions

of HR 2125 raise the issue of whether the United States wants the freight rail system to continue to be funded and developed by the private sector, or to run the risks, if we are willing to change the policy of the last 27 years, of selectively subsidizing certain shippers or regions, whether directly or indirectly.

The principles and policy of differential pricing are generally recognized as the most effective path to railroad pricing. There are, however, some unavoidable realities that are imbedded in the characteristics of any large transportation network that is both complex and where market-based pricing is used to maximize contribution and avoid the need for public (taxpayer) support:

1. Pricing – For any mode or sector (e.g., air, utilities, package delivery, rail) where pricing policy permits differential pricing, there will always be some users who pay more and some who pay less. In the airline industry, it is not uncommon to be sitting next to someone who paid three or four times your fare, or to have on the other side of you a person who paid a quarter to a third of your fare. As can be observed on page II-20 and in the appendix (pages II-26 and II-27) of the attached supporting data, there is a wide range of revenue to variable cost (R/VC) relationships for all traffic and for each commodity, whether one considers all U.S. railroads or one particular railroad (see UP example, page II-21).

   Human and economic nature being what it is, no one in the United States or any other economy likes to be in the differential pricing bucket that is highest or higher than others. No one celebrates paying higher prices, no traffic manager or shipping executive receives a bonus or is compensated for being at the high end of the R/VC range. R/VC ratios for some less competitive traffic movements can be two or three times those of the most competitive traffic moving at lower ratios. It is to be expected that there will be a continuous and natural tendency of those parties paying higher ratios to try and modify the pricing structure to restrict the workings of differential pricing. It has been my experience, however, that differential pricing does not work when regulation cuts off one end of the range and tries to move prices artificially to lower R/VC ratios. Eventually, the loss of contribution from higher rated traffic forces an increase in prices for competitive traffic, which often leads to a cycle of volume loss (see pages II-17 to II-19).

2. Service – The overall service and throughput of the U.S. freight rail system is the envy of the world, and many U.S. rail network planning and business practices have become global benchmarks. Unfortunately, however, service failures do occur, and far more often than the carriers and certainly the shippers would like. (One only has to look at the performance of the airline industry this summer to see how personal service failures can sometimes become.) While all carriers aspire to highly reliable service levels, there are some structural complexities that make attaining those levels a considerable challenge. For example, in the United States, there are an estimated two million origin/destination combinations, and in 2006, 1.31 million railcars[1] moved 32.1 million carloads[2] (and 1.96 trillion tons[3] in total

[1] Source: AAR Railroad Equipment Report, 2006, Association of American Railroads. Cars as of January 1, 2006. Cars with marks of U.S. railroad subsidiaries of Canadian railroads are excluded from this total.

[2] Source: Freight Commodity Statistics, 2006, Association of American Railroads.

[3] Source: Freight Commodity Statistics, 2006, Association of American Railroads.

were moved by the Class I railroads). Recent network and operating improvements, coupled with access to private capital, should move the system to higher reliability levels and in some cases improve transit times.

Even in a situation where some are unhappy about being on the high end of the rate curve or have experienced the frustration of even one service failure, it is important to recognize that the U.S. freight rail system is still the best in the world – and I believe it has the opportunity to get even better. Here are some important facts, generalized somewhat to fit into my five-minute time limit:

- U.S. rail freight rates are among the lowest in the world. The cost to move one ton one mile in the U.S. can be as little as 10 percent of the cost in other countries (page II-5).
- Not only are U.S. freight rates extremely low, but virtually no taxpayer contribution is required for either service or infrastructure. In most countries, taxpayers cover some part of infrastructure variable operating cost and generally all capital expenditures; in the United States, they cover virtually none of these costs (page II-6).
- The U.S. system is the most productive in the world and consumes far fewer resources to move one ton over one mile than any other in the world (pages II-3 and II-4). All again without the need for taxpayer contribution.
- The U.S. railroads reinvest more capital in infrastructure and equipment than almost any other sector of the economy, with a low return on equity (page II-15).
- As was envisioned and hoped for at the time of the Staggers Act, the performance of the railroads is attracting private capital in large amounts to support critical growth and infrastructure replacement needs. The top 25 shareholders of the U.S. carriers have invested more than $42 billion (page II-9).

I would like to cite one recent example of the capacity of the private sector to fund growth and expansion. Some believe a third carrier and route with access to the Powder River Basin (PRB) – generating additional carrier competition in the PRB – would be a good thing. After many years of planning, permitting, and engineering work, the Dakota, Minnesota, & Eastern (DM&E) railroad was ready in late 2006 to move to the next step of line construction. I will oversimplify a bit, but as many of you know, the railroad requested public assistance in the form of a loan to assist with the building of the line into the coal fields. On February 26, 2007, Federal Railroad Administrator Joseph H. Boardman denied a $2.3 billion Railroad Rehabilitation and Improvement Financing (RRIF) loan application from the DM&E, concluding it posed an unacceptably high risk to federal taxpayers. On September 6, 2007, eight months after the government turned down participation in this infrastructure and market access project, the Canadian Pacific Railway announced its intention to purchase the DM&E, with the right to finance and build the line into the PRB.

The DM&E situation represents an example of how the system fostered by the Staggers Act was meant to work – with the private sector (CP) raising funds and accepting the risk of new line and capacity construction as part of its acquisition of the DM&E, since the government did not find it

possible to make this investment. In the future, if the country is to meet projected or new capacity requirements, the freight rail industry must continue to offer sufficient returns to attract growth capital, as well as encouraging public participation.

I believe that there are several aspects of HR 2125 that, if implemented, will likely lead to a decrease in private capital flowing to the industry and/or and increase the cost of funds. Additionally, if the revenue structure of the industry is moved away from market-based differential pricing (where approximately one-third of traffic movements support price levels above an R/VC ratio of >180), carriers will likely reduce capital spending and have less ability to support growth.

An effective differential pricing system requires higher rates on less competitive traffic (i.e., traffic in areas of less effective competition) to offset lower rates on highly competitive traffic where revenue above long-term variable cost is too low to fully support the long-term viability of private carriers.

- For example, in 2003, the STB calculated that 12.61 percent of all movements had an R/VC < 100; 54.54 percent had an R/VC of 100 to 180, and 32.86 percent had an R/VC > 180.[4] It is highly likely that traffic with an R/VC of <100 or at the low end of the 100 to 180 range moves in areas or under circumstances of higher competition. It is also likely that many of the rates for traffic with R/VC ratios of >180 arise in situations where there is less (or in the language of HR 2125, inadequate) competition.

- The same calculation made by the Interstate Commerce Commission (ICC) in 1993 found that 32.05 percent of all traffic had an R/VC of >180, suggesting that in both the early 1990's and in 2003 something close to a third of rail traffic is generally priced above 180 to offset lower priced traffic or movements with a long-term variable cost (LTVC) of less than 100.[5]

It has been my experience that the stability of the revenue profile has been an important factor in reducing the risk penalties for capital funding; attempts to move revenue from higher to lower categories will not only impact specific rail economics but likely the cost of capital as well.

There are several provisions of HR 2125 (for example, relative to the existence of areas of inadequate rail competition) that propose an actual or constructive capping of freight rates, most often at an R/VC ratio of 180. I suspect the inadequacy of the competitive structure in the eyes of the proponents of the legislation means that R/VCs are higher than in more competitive locations or situations. As I stated before, everyone would like a lower rate. I am sure, if given the choice, all shippers would like to move to the R/VC category where ratios are less than 100. The reality is that you cannot have a sustainable U.S. rail system, able to support maintenance and growth, without the full range of differential (Ramsey) pricing options. As I will comment on below, the

[4] Class I Railroad Revenue-Variable Cost Ratios for 2003, from Waybill data, Surface Transportation Board.

[5] Class I Railroad Revenue-Variable Cost Ratios for 1993, from Class I Railroad R-1 reports, memo from Walter Asmuth, Interstate Commerce Commission, May 23, 1995.

R/VC of 180 was never intended to be a determinant of railroad financial performance. It was established to set a point where, for some commodities, a regulatory review could occur. I believe there was nothing in the creation of the Staggers Act or proceedings since that have set an R/VC of 180 as a goal. A cap of 180 on movements that have fewer competitive options is not sufficient to provide funds for a healthy rail network.

To get a sense of the revenue deficiency that could occur if rates were capped at an R/VC of 180, it may be useful to consider the Revenue Shortfall Allocation Method (RSAM) used by the Surface Transportation Board (Ex Parte 347) to measure the average markup above a carrier's variable cost that a carrier would need to charge all of its potentially captive traffic (i.e., traffic priced above an R/VC of 180) in order for the carrier to recover its non-variable cost.

Currently, there is no situation, based on the RSAM calculation, where the average markup for captive traffic is below 180 and in most situations it is above 200 (page II-24). Even in these cases, the current pricing patterns as measured by the STB do not provide sufficient contribution from less competitive traffic to make the railroads fully revenue adequate. Further case by case or broad scale reclassification of movements from competitive to lower R/VCs will have the direct effect of reducing overall revenue and weakening the financial position of the carriers. Using the 2003 STB data, the proposed legislation would have reduced, or in the extreme eliminated, the 32.86 percent of R/VC>180 movements that helped offset the 12.61 percent that had R/VC ratios of less than 100 and the lower-ratio movements in the 100 to 180 category. The HR 2125 legislation is silent on how the carriers will make up this lost contribution from higher R/VC traffic and still have sufficient returns to fund growth and maintenance.

The legislation also appears to use the R/VC ratio of 180 as a performance target, with some view that 180 defines a level of pricing that is acceptable or even recommended. To my recollection, the 180 threshold (originally set at 162 in 1980), was simply the R/VC level at which certain segments of traffic could request regulatory intervention. It was in essence the gate which opened the door to regulatory review. As far as I can recall, I know of no analysis by the ICC (the STB's predecessor agency), Congress, or any other parties that suggested that 180 was an end point for revenue adequacy, proper returns, or a ceiling on rates. The very existence of the RSAM process used by the STB confirms that it was anticipated that some rates by necessity would need to be above 180.

In addition, the suggested changes to the regulations on reciprocal switching, while an understandable objective for customers who believe they have inadequate competitive options and would like to move into the range of lower R/VC rates, would disrupt the distribution of differential prices that support the current industry structure. Like the proposed revenue cap, expansion of a second and third carrier in terminal areas would have the effect of reducing the traffic that is available to balance lower-rated, more competitive movements. In their terminal and switch district analysis, carriers most often find that investment in support facilities cannot be amortized by terminal activities alone at such locations. Contribution from the linehaul movement is needed to cover both terminal operating and capital expenditures. The wholesale expansion of reciprocal switching zones could in many cases raise the risk of not recovering the investment cost and deter capacity improvements. While I do not agree with the expansion of the reciprocal switching zones,

if it is seriously considered, a requirement to compensate the terminal owner for not only local cost but lost linehaul contribution should also be considered.

Expansion of reciprocal switching also will complicate rail operations. Today, carriers are trying to consolidate the number of origins and destinations to reduce system complexity, sorting requirements, and traffic fragmentation. The HR 2125 switching provisions will have the effect of doubling the sorting activity of the carriers serving an origin or destination. What is now a single line origination with a subsequent linehaul will create a requirement for a second block or sort in the system. Multiply this times the number of new reciprocal switching options, and the expansion of operating sorting requirements could offset the efficiency efforts being pursued by the carriers.

Finally, there are many issues with Final Offer Arbitration (FOA). One of the most damaging and unexpected outcomes may be that the movement from a regulatory policy based on analysis and legal process to baseball arbitration that is largely founded on gaming theory and random outcomes will create a high degree of risk and uncertainty around carrier revenue levels. It is likely that if there are a large number of such cases, the risk of uncertainty could return some level of risk penalty to the rail cost of capital.

Thank you and I would be pleased to answer any questions now or later in the hearing.